

Explanatory notes for SVSP's 'Guidelines for calculating and disclosing the costs of structured products'

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Asset management costs for structured products

In its Directive (1), the Occupational Pension Supervisory Commission (OPSC) issued cost concept requirements for using collective investment schemes in occupational pensions. Collective investment schemes that meet these requirements are classified as cost transparent; other collective investment schemes are considered to be non-cost transparent. The definition of collective investment schemes used in (1) is more comprehensive than that used in the Swiss Collective Investment Schemes Act (*Kollektivanlagengesetz*) and explicitly includes structured products.

Previously there was no cost concept for structured products approved by the OPSC in accordance with the requirements defined in (1).

This paper proposes a cost concept for structured products that has been submitted to the OPSC for review and approval.

EU Regulation on key information documents

Regulation (European Union) No. 1286/2014 (Regulation on key information documents for packaged retail and insurance-based investment products, known as the PRIIPs Regulation for short) came into force at the end of 2014 and has been applied since 3 January 2018 (2). The aim of the Regulation – the scope of which is the European Economic Area (EU member states and EFTA member states (excluding Switzerland)) – is to improve investor protection. For packaged investment products (PRIIPs), investors should receive transparent information on financial products in the form of clear, neutral and standardised key information documents (KIDs). In particular, PRIIPs also include structured products.

The information provided in the KIDs and the presentation of this information are defined in detail in the regulatory technical standards (RTS) of the European Commission (3). In particular, the KIDs provide information on the costs of the relevant structured product.

OPSC cost concept requirements for structured products

In (1) the costs of investments are allocated to one of the following three categories:

- Fees for asset management, also known as the total expense ratio (TER costs),
- Transaction and tax costs (TTC costs),
- Other costs or supplementary costs (SC costs).

To ensure that a collective investment scheme can be classified as cost transparent, pension funds must report at least the following costs in the income statement:

- TER costs within the collective investment schemes,
- TTC costs at pension fund level.

While TTC costs are calculated and documented by the pension fund, TER costs are calculated by the provider of the collective investment scheme and provided to the pension fund.

The following principles must be followed in accordance with Directive (1) when calculating the TER:

1. Calculation on the basis of the invested net assets,
2. Complete inclusion of TER costs,
3. Retrospective record of TER costs for one accounting year,

4. Economic view of cash flows,
5. Review of the calculation by an auditor,
6. Separate calculation for each collective investment scheme with different costs,
7. Composite (synthetic) TER for multi-level collective investment schemes.

The OPSC's cost concept requirements are compared below with the requirements for determining and disclosing costs in accordance with the Delegated Regulation on KIDs for PRIIPs (3). First, the next section provides an overview of cost information in accordance with the PRIIPs Regulation.

Reporting costs in KIDs for PRIIPs

The costs of a PRIIP are disclosed in the 'What are the costs?' section of the key information document (3). The costs are presented in detail in the 'Costs over time' and 'Composition of costs' tables.

In the 'Costs over time' table, the issuer of the structured product specifies the summary cost indicator of the total aggregate costs of the structured product in monetary and percentage terms for the specified time period (impact on the yield (RIY) per year).

In the 'Composition of costs' table, the issuer specifies the following:

- Any one-off costs such as entry and exit costs, presented in percentage terms,
- Any recurring costs such as management fees, portfolio transaction costs per year and other recurring costs per year, presented in percentage terms,
- Any incidental costs such as performance fees, presented in percentage terms.

The approach to determining costs is described in detail in (3) and is partly reiterated at this point with regard to calculating the implicit costs of structured products (Paragraph 36 et seq. in (3)):

- *For the purposes of the calculation of the implicit costs embedded in PRIIPs, the PRIIP manufacturer shall refer to the issue price and, after the subscription period, to the price available to purchase the product on a secondary market.*
- *The difference between the price and the fair value of the product is considered as an estimation of the total entry costs included in the price.*
- *Fair value is the price that would be received for selling an asset or paid to transfer a liability in an orderly transaction in the principal (or most advantageous) market at the measurement date under current market conditions (i.e. an exit price) regardless of whether that price is directly observable or is estimated using another valuation technique.*
- *The fair value policy that governs the measurement of the fair value shall set a series of rules, including in the following areas: a) governance; b) methodology for the calculation of the fair value.*
- *The rules referred to for measuring the fair value shall aim at outlining a valuation process that: a) complies with the applicable accounting standards in relation to fair value; b) makes sure that internal pricing models for PRIIPs are consistent with the methodologies, modelling and standards used by the PRIIP manufacturer to value its own portfolio under the assumption that the product is available for sale or held for trading; c) is consistent with the level of complexity of the product and the type of underlying; d) takes into account the issuer credit risk and the uncertainty about the underlying; e) sets the parameters for identifying an active*

market in order to avoid risk mispricing that could lead in extreme cases to significantly inaccurate estimates; f) maximises the use of relevant observable market inputs and minimises the use of unobservable inputs.

- *The fair value of a structured product shall be determined on the basis of: a) market prices, where available or efficiently formed; b) internal pricing models using as an input market prices that are indirectly connected to the product, derived from products with similar characteristics (comparable approach); c) internal pricing models based on inputs that are not derived directly from market data for which estimations and assumptions must be formulated (mark-to-model approach).*

Based on this approach to determining the costs of a PRIIP, generally the entry costs when purchasing a product will be greater than zero. By contrast, in many cases the exit costs will be equal to zero. This is due to the fact that the exit costs in the 'Composition of costs' section of the key information document are calculated for the recommended holding period (hereinafter also shortened to RHP) of the product. In the case of investment products, the recommended holding period of the product is in most cases identical to the maturity of the product. As this is repaid under the conditions defined in the offer terms and conditions upon maturity of the product, there are no exit costs for the investor either. In the case of open-ended products, in many cases the investor has the opportunity to make use of regular (daily or monthly) exercise rights in accordance with product terms and conditions. No exit costs are incurred here either, as the product is not sold by the investor in the secondary market upon exercise but is instead repaid by the issuer under defined conditions. This means that exit costs are only incurred when the investor does not hold the product to maturity or, in the case of open-ended products without exercise rights, sells the product in the secondary market.

The calculation of the total costs shown in the KID expressed as a percentage (Reduction in Yield – RIY) is described in detail in Regulation (3) and is based on an estimate of future payments. The RIY is calculated as the difference between two percentages i and r , where r is the annual internal rate of return in relation to the investments made by the buyer and the estimated payments to the buyer during the recommended holding period and i is the annual internal rate of return for the respective cost free scenario. The estimation of future payments to the buyer of the product is based on the moderate scenario set out in the key information document.

The key information document for a PRIIP is maintained for the entire PRIIP offer period in accordance with the PRIIPs Regulation.

The financial services provider offering a structured product to a pension fund provides the pension fund with the latest KID when the pension fund acquires the structured product.

The issuer of the structured product is also obligated to provide up-to-date cost information on a website that is accessible to the pension fund free of charge. The cost information provided on this website is calculated based on the same regulatory approach as the costs disclosed in the KID. The website containing the cost information can be provided by the issuer or a third party. As a result, SVSP can arrange an external solution for providing cost information with a data retention service provider. The cost information for a product should generally be accessible by the pension fund at all times for a given reference date during the term of the product and for at least two years afterwards.

The information in the KIDs enables the pension fund to estimate the ex-ante costs when purchasing the product. The aforementioned cost information is published on a website to enable the charging of ex-post costs on which the income statement of the pension fund is based.

This cost information on a structured product provided by the issuer enables the pension fund to charge up-to-date ex-post costs when buying and selling the product.

- At the time of purchase: purchase costs, i.e. initial costs;
- At the time of sale: selling costs, i.e. exit costs and any recurring costs incurred (since the start of the calendar year or since the purchase date, if the purchase was made after the start of the calendar year);
- Annual cost summary at the end of the year: costs previously incurred for the product since the start of the year or since the product was purchased (if the structured product was acquired in the same calendar year). These previously incurred costs include initial costs (if the structured product was acquired in the same calendar year), recurring costs (if applicable) and exit costs (if the structured product was sold in the same calendar year).

This means that the issuer must provide the following cost information on a website that is accessible to the pension fund free of charge:

- ISIN
 - The ISIN serves as a unique identifier for the structured product
- Cost Reference Date
 - Date to which the cost information relates
- Structured Product Quotation: Percentage / Units
 - Information on whether the structured product is listed in percentage or unit terms
- One-Off Costs Structured Product Entry Cost Ex-Post
 - Entry costs incurred when purchasing a structured product on the Cost Reference Date. This information is provided in percentage or absolute terms (in the Structured Product Currency), depending on the Structured Product Quotation
- One-Off Costs Structured Product Exit Cost Ex-Post
 - Exit costs incurred when selling a structured product on the Cost Reference Date. This information is provided in percentage or absolute terms (in the Structured Product Currency), depending on the Structured Product Quotation
- Structured Product Ongoing Costs Ex-Post
 - Absolute amount (in the Structured Product Currency) of recurring costs per day on the Cost Reference Date
- Structured Product Ongoing Costs Ex-Post Accumulated
 - Absolute amount (in the Structured Product Currency) of recurring costs accumulated between 1 January of the year of the Cost Reference Date until the Cost Reference Date
- Structured Product Incidental Costs Ex-Post
 - Annualised incidental costs. This information is provided in percentage or absolute terms depending on the Structured Product Quotation
- Structured Product Reference Value Ex-Post
 - Reference price of the structured product on the Cost Reference Date. The costs of a structured product listed in units are based on this reference price. The costs of a structured product listed in percentage terms must be multiplied by this value to determine the costs per unit.
- Structured Product Currency

- Trading currency of the structured product

Only structured products from issuers who provide the pension fund with the above cost information are covered by the cost concept. Structured products for which the above cost information is not provided do not fulfil the cost concept requirements and are therefore considered to be non-cost transparent.

The pension fund can use this cost information to charge ex-post costs on an accrual basis.

A cost concept for structured products

This chapter explains that the presentation of costs in the key information document and on a website containing cost information about the relevant structured product meets the OPSC cost concept requirements for structured products. It also shows that the seven requirements for a TER cost concept (see Page 3) are being met. These seven requirements are referenced and the above numbering adopted below.

1. **Calculation on the basis of the invested net assets:** The summary cost indicator is given in monetary (and percentage) terms in the key information document. When entering this figure in monetary terms, it is assumed that the buyer of the structured product has invested CHF 10,000 (or in another currency according to the trading currency of the structured product) in the PRIIP. The TER of the structured product in relation to invested assets can be determined directly using this monetary figure (the TER is calculated by dividing the summary cost indicator as a monetary figure and the investment amount as stated in the KID). The costs are disclosed in the KID based on invested net assets and show reduction in yield calculations. The costs published on the issuer's website are ex-post costs in relation to invested net assets. This means that the cost information on the website provided by the issuer meets the requirements of a TER cost concept.
2. **Complete inclusion of TER costs:** The summary cost indicator of a structured product corresponds to the reduction in yield based on total costs. Full details of the summary cost indicator calculation are provided in (3) and are cited and summarised here. Total costs are the sum of:
 - a. **one-off costs:** These are entry or exit costs that are either paid directly by the pension fund or deducted from a payment received by or due to the pension fund. One-off costs include, but are not limited to, the following types of costs that are taken into account in the cost amount disclosed in the KID: i) one-off entry costs and fees: sales commissions; structuring costs; hedging costs; legal advisory fees; costs for capital guarantees; ii) one-off exit costs and fees: proportional fees; bid-mid spread to sell the product.
 - b. **recurring costs:** These are payments regularly deducted from all payments due to the pension fund or from the investment amount, such as regularly incurred portfolio transaction costs and other recurring costs.
 - c. **incidental costs:** The vast majority of structured products do not incur any incidental costs.

Taking the aforementioned costs into account means that all costs set out in the requirements for a TER cost concept are recorded in the KID summary cost indicator. The same applies to the cost information for a structured product published on the issuer's website.

3. **Retrospective record of TER costs for one accounting year:** The issuer of the structured product provides up-to-date information about the initial, recurring and exit costs of the relevant product on a website based on the PRIIPs Regulation. This information enables the pension fund to easily and efficiently see all the necessary information about costs when purchasing or selling a structured product. As a result, this information meets the requirement to keep a retrospective record of TER costs for one accounting year.
4. **Economic view of cash flows:** The guidelines for the summary cost indicator in the key information document for a structured product, together with the presentation of costs on the issuer's website, represent a new level of disclosure to investors in structured products. It means that all costs, particularly any possible distribution fees, are included in the costs. This allows investors to use the cost information to take an economic view of cash flows.
5. **Review of the calculation by an auditor:** Relevant national supervisory authorities within the EEA are responsible for monitoring compliance with the Regulation on key information documents for PRIIPs. Each issuer of structured products in Switzerland is also subject to supervision measures carried out by internal and external banking law auditors in particular and is also required to clearly document its processes and concepts for calculating TER. As a result, a TER cost concept according to guidelines adopted by SVSP and based on the PRIIPs Regulation is supported by a broad supervisory documentation and compliance framework in Switzerland and is subject to review by the relevant auditors.
6. **Separate calculation for each collective investment scheme with different costs:** The issuer prepares and provides a key information document assigned to each individual PRIIP for every structured product in accordance with the Regulation as well as preparing and providing cost information on a website.
7. **Composite (synthetic) TER for multi-level collective investment schemes:** Structured products with multi-level collective investment schemes are not currently included in the TER cost concept. One example of this is a structured product for a basket of structured products. At present, the issuers' data management systems are not yet all able to correctly show the costs of the constituent parts of such a product. As a result, not all of the incurred costs can be correctly recorded. Work is under way to be able to correctly disclose the TER costs for these products. As soon as this happens, the cost concept will be expanded to include structured products with multi-level investments.

The PRIIPs Regulation, the cost information in the KIDs and the cost information on issuers' websites meet all of the OPSC's requirements for a TER cost concept for structured products. Structured products can be classified as cost transparent once such a cost concept has been approved by the OPSC. This will enable pension funds to satisfy their investment needs more effectively by selecting from a larger class of collective investment schemes.

On 20 September 2019, the SVSP adopted its 'Guidelines for calculating and disclosing the costs of structured products' and submitted these guidelines to the OPSC for its approval as a cost concept for structured products based on the reasons set out above.

List of references

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